INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute involved	2
Statement	3
Argument	8
Conclusion	14

CITATIONS

Cases:

Board v. *Commissioner*, 51 F. (2d) 73, certiorari denied, 284 U .S. 658	10
Bowers v. *Kerbaugh-Empire Co.*, 271 U. S. 170	11
Brown v. *Helvering*, 291 U. S. 193	10
Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359	11
Commissioner v. *Brooklyn Union Gas Co.*, 62 F. (2d) 505	10
Commissioner v. *Lyon*, 97 F. (2d) 70	10
Commissioner v. *Turney*, 82 F. (2d) 661	12
Doyle v. *Commissioner*, 110 F. (2d) 157, petition for certiorari pending, October Term, 1940, No. 111	13
Freuler v. *Helvering*, 291 U. S. 35	11
Garrett v. *Jensen*, 44 Cal. App. 99	11
Great Southern Life Insurance Co. v. *Commissioner*, 33 B. T. A. 512, affirmed on other issues, 89 F. (2d) 54	12
North American Oil Consolidated v. *Burnet*, 286 U. S. 417	8, 9, 10, 11, 12, 13, 14
Oldfield v. *Bank of America*, 6 Cal. (2d Series) 103	11
Saunders v. *Commissioner*, 101 F. (2d) 407	10
Stoner v. *Commissioner*, 79 F. (2d) 75	13
United States v. *Safety Car Heating and Lighting Co.*, 297 U. S. 88	11
Victoria Paper Mills Co. v. *Commissioner*, 32 B. T. A., 666 affirmed without opinion, 83 F. (2d) 1022	11

Statute:

Revenue Act of 1932, c. 209, 47 Stat. 169:	
Sec. 22	2
Sec. 23	3

257773—40

In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 335

ALAMITOS LAND COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 23–50) is reported in 40 B. T. A. 353. The opinion of the Circuit Court of Appeals (R. 138–148) is reported in 112 F. (2d) 648.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 10, 1940 (R. 149). The petition for a writ of certiorari was filed on August 13, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the petitioner realized taxable income in 1932 when its lessee paid the petitioner $522,895.11 pursuant to a judgment of the Superior Court of California which was reversed in 1935 by the Supreme Court of California.

2. Whether interest received by the petitioner in 1932 and 1933 on the fund of $522,895.11 was taxable income.[1]

STATUTE INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 22. GROSS INCOME.
>
> (a) *General definition.*—"Gross income" includes gains, profits, * * * of whatever kind and in whatever form paid, or from * * * businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

[1] A further question was presented to but not decided by the Board of Tax Appeals or the Circuit Court of Appeals, namely, whether, if the judgment was taxable income in 1932, a deduction may be taken in that year for a contingent fee which the petitioner had agreed to pay in an amount equal to 35 percent of the recovery from its lessee. The case was remanded to the Board of Tax Appeals for a decision of this point.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

STATEMENT

The pertinent facts as stipulated and found by the Board of Tax Appeals (R. 25–36) are as follows:

In 1921, the petitioner, as lessor, entered into an oil and gas lease with the Shell Oil Company of California, hereinafter called Shell. Under the terms of the lease, the petitioner was to receive 16⅔ percent of all oil and gas produced from the leased property. Oil and gas have been produced upon the property by the lessee since 1921, and each year the petitioner has accrued on its books and in its income-tax return the December royalty, payable in January (R. 25).

On September 1, 1930, the petitioner entered into a contract with Shepard-Pendleton, Ltd., a corporation engaged in petroleum engineering work, pursuant to which the latter was employed to check the methods which Shell had used in determining the quantity and quality of the oil produced from the leased premises and the method of computing the royalties to be paid to the petitioner. The petitioner agreed to pay Shepard-Pendleton for its

services a sum equal to 35 percent of the amount recovered from Shell, whether with or without litigation. Shepard-Pendleton was to pay all attorney's fees and court costs (R. 25–26).

As Shepard-Pendleton determined that, due to Shell's incorrect method, the latter owed the petitioner about a half million dollars, the petitioner brought suit in the Superior Court of California in 1931 against Shell for this sum and also asked for the forfeiture of the lease because of Shell's failure to pay the proper royalties (R. 26–27). On June 20, 1932, judgment was entered in favor of the petitioner for additional royalties in the amount of $490,805.75, interest in the amount of $31,226.86, and court costs of $862.50. The judgment also ordered cancellation of the lease but provided that Shell might be relieved of such forfeiture if it paid the petitioner the sums allowed by the judgment on or before August 29, 1932 (R. 27).

The lease involved was very valuable to the lessee, and, to prevent a forfeiture, Shell, on July 8, 1932, tendered to the petitioner a cashier's check for $522,895.11. Accompanying the check was a letter from Shell to the petitioner, in which it was stated that the payment was made only to avoid a forfeiture of the lease and that Shell was not waiving its right of appeal for the purpose of securing a reversal of the judgment (R. 28).

On July 12, 1932, the petitioner, through its attorneys, wrote a letter to the attorneys for Shell in

which it was stated that the payment by Shell would be considered as precluding an appeal from the judgment. It also stated that if Shell attempted to appeal, the petitioner would move to dismiss the appeal upon the ground that the judgment had been satisfied by the payment. The petitioner offered to return to Shell the $522,895.11, if Shell felt that its interests might be prejudiced by having made the payment. Shell did not agree with the conditions expressed by the petitioner and did not ask for the return of the money (R. 28–29).

On July 14, 1932, Shell took an appeal to the Supreme Court of California from all portions of the judgment with the exception of paragraphs sixth and seventh as to which the petitioner took a cross appeal, but its motion was denied on January 9, 1933 (R. 29).

On September 22, 1932, the petitioner deposited the check for $522,895.11 in the Long Beach Branch of Security-First National Bank of Los Angeles in a term deposit account bearing interest at the rate of 3½ percent per annum. On its books, the petitioner made a journal entry debiting "Deposit in connection with pending action vs. Shell Oil Co.—$522,895.11" and crediting "Reserve for contingent liability in connection with pending action vs. Shell Oil Co.—$522,895.11." This was followed by a statement explaining the conditions under which Shell had made the payment. On June 14, 1933, the petitioner, out of the funds so deposited, purchased

United States Treasury Notes for $52,000, and on July 24, 1933, purchased Treasury Notes for $205,000 (R. 29–31).

On April 26, 1935, the Supreme Court of California reversed the judgment of the lower court in its entirety except that it affirmed the judgment as to paragraphs sixth and seventh (R. 31).

On May 28, 1935, Shell made a written demand upon the petitioner for restitution, demanding repayment of the sum of $522,895.11, together with interest at 7 percent amounting to $105,696.44. On June 4, 1935, the petitioner tendered to Shell the sum of $522,895.11, plus $41,256.90, being the interest actually received by the petitioner during the time the principal had been in the petitioner's custody, and the sum of $11,595.31, representing profits accruing from the purchase and sale of United States Treasury Notes, or a total of $575,747.32. The petitioner gave to Shell a complete accounting of the $522,895.11 while in the petitioner's custody (R. 31–32).

After receiving the petitioner's check for $575,747.32, Shell sued the petitioner for the additional sum it claimed as due. Also, subsequent to the Supreme Court's decision, the petitioner filed an amended complaint against Shell and Shell filed an answer and the case was at issue in 1938. While these suits were awaiting trial, the parties entered into an agreement in 1938 whereby the petitioner received $100,000 and both actions were dismissed (R. 32, 34–35).

Before entering into the settlement, the petitioner obtained the consent thereto of Shepard-Pendleton and agreed to pay the latter 25 percent of the $100,000 as its fee. This sum was paid Shepard-Pendleton in 1938 as its fee in the litigation against Shell (R. 35).

In its 1932 income-tax return, the petitioner excluded from income the $522,895.11 received from Shell and the interest earned thereon and did not deduct the sum of $182,205.76 representing its contingent liability to Shepard-Pendleton. In its 1933 return, the petitioner also excluded an $18,208.57 increase in the deposit account (R. 35).

On its 1935 return, the petitioner did not claim any deduction on account of having returned to Shell the $522,895.11, plus accretions, but paid an income tax for the year 1935 of $7,081. The petitioner, within the statutory period allowed therefor, filed a claim for refund which had not been acted upon at the time of the Board's hearing (R. 36).

During 1932 and 1933, the petitioner kept its books and filed its income-tax returns on the accrual basis as to royalties (R. 36).

The Board held that the fund of $522,895.11 and the accretions thereto in 1932 and 1933 were not income to the petitioner in those years. In view of this decision, the Board stated that it was not necessary to consider whether, if these sums had constituted income, petitioner would have been entitled to a deduction in the amount of its contingent lia-

bility to Shepard-Pendleton (R. 44). An order was entered determining that there was no deficiency due in 1932 and 1933 (R. 50).

The Circuit Court of Appeals held that the amount of the judgment should be included in petitioner's gross income. It therefore reversed the order of the Board and remanded the case for determination of the question of petitioner's right to a deduction because of its contingent liability to Shepard-Pendleton (R. 145, 148).

ARGUMENT

1. The question presented in this case has already been decided by this Court in *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417. The petition suggests no persuasive reason why the issue settled in the *North American Oil* case should now be reexamined.

The facts in the *North American Oil* case are strikingly similar to those in the case at bar. The taxpayer there operated oil land, the legal title to which stood in the name of the United States. The Government, claiming also the beneficial ownership, instituted suit to oust the taxpayer from possession and, prior to 1916, secured the appointment of a receiver to operate the property. In 1917 the Government's bill was dismissed by the District Court and in the same year the receiver paid to the taxpayer the net profits which had been earned from the property in 1916. The Government took an appeal, without *supersedeas*. In

1920 the Circuit Court of Appeals affirmed the decree of the District Court, and in 1922 a further appeal to this Court was dismissed by stipulation.

The Commissioner determined that the amount paid to the taxpayer by the receiver in 1917 was income to it for that year. The company contended, on the other hand, that the money was income either for 1916, when earned, or for 1922, when the litigation was finally determined. It urged that in 1917 it was not known whether the decree of the District Court would be affirmed or reversed and that, because of the possibility of reversal, the money paid pursuant to the decree could not be considered income until the litigation was at an end. The Court, holding that the taxpayer received the income in 1917, stated (286 U. S. 424):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. [Citing cases.] If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year * * *.

Petitioner urges that the *North American Oil* case is distinguishable because there the original

decree was ultimately affirmed while here it was reversed. The contention misconceives the basis of this Court's ruling. The taxability of income in any particular accounting period depends solely on the situation existing in that period and cannot be affected by what happens during a subsequent accounting period. Thus, the taxability of the North American Oil Consolidated on the funds it received in 1917 was dependent upon the situation then existent and could not be altered by what occurred in a later year. Looked at from the standpoint of 1917 there was the same possibility that the decree in favor of the North American Oil Consolidated would be reversed and that the company would have to restore the funds which it received as, in the present case, there was the possibility in 1932 that the judgment in favor of the taxpayer would be reversed and the amount received would have to be repaid. But this Court held that the possibility of reversal, with the consequent liability for repayment, did not affect the situation; the controlling factor was that the taxpayer had received the money during the tax year under a claim of right and without restriction as to its disposition.[2]

Here, too, the taxpayer received the money during the tax year under a claim of right and without

[2] Accord: *Brown* v. *Helvering*, 291 U. S. 193; *Commissioner* v. *Brooklyn Union Gas Co.*, 62 F. (2d) 505 (C. C. A. 2d); *Commissioner* v. *Lyon*, 97 F. (2d) 70 (C. C. A. 9th); *Board* v. *Commissioner*, 51 F. (2d) 73 (C. C. A. 6th), certiorari denied, 284 U. S. 658; *Saunders* v. *Commissioner*, 101

restriction as to its disposition. As pointed out by the court below, under the law of California petitioner was not a trustee of the fund while the litigation was in progress but had the right to use the money in any fashion that it saw fit. *Oldfield* v. *Bank of America Etc. Assn.*, 6 Cal. (2d Series) 103; *Garrett* v. *Jensen*, 44 Cal. App. 99. The fact that petitioner decided not to exercise its power of absolute dominion over the fund but instead placed it in a special deposit account did not change the character of the control which it had over the money when it received it. Consequently, the rule in the *North American Oil* case is, as the court below held, directly applicable.

2. Petitioner contends that the decision below is in conflict with four decisions of this Court. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170; *Freuler* v. *Helvering*, 291 U. S. 35; *United States* v. *Safety Car Heating and Lighting Co.*, 297 U. S. 88; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. No useful purpose would be served by pointing out the obvious distinctions between those cases and the present one. It suffices to note that two of the cases were decided before the decision in the *North American Oil* case and were not deemed to affect the result, and that in the other two the *North American Oil* decision was either cited with approval or specifically held inapplicable. 291 U. S.

F. (2d) 407 (C. C. A. 10th); *Victoria Paper Mills Co.* v. *Commissioner*, 32 B. T. A. 666, affirmed without opinion, 83 F. (2d) 1022 (C. C. A. 2d).

at 42–43; 297 U. S. at 94. Since, as we have shown, the decision below is directly in accord with the decision in the *North American Oil* case, it cannot successfully be maintained that it is in conflict with the other cases cited.

3. Petitioner's contention that the decision in the present case is in conflict with decision of other circuit courts of appeals has no greater merit.

In *Great Southern Life Ins. Co.* v. *Commissioner,* 33 B. T. A. 512, affirmed on other grounds, 89 F. (2d) 54 (C. C. A. 5th), the taxpayer held bonds as collateral for a loan. Upon nonpayment of the loan, the taxpayer appropriated the collateral for its own use and thereafter received various sums as interest upon the bonds. Prior to the appropriation, however, the taxpayer had received notice that certain of the bonds were stolen property and it ultimately had to return those bonds to the true owner. The Board held that the taxpayer was not liable for income tax on the interest paid on the bonds because it did not receive the payments under a claim of right and without restriction as to their disposition. *North American Oil Consolidated* v. *Burnet, supra,* was expressly distinguished.

In *Commissioner* v. *Turney,* 82 F. (2d) 661 (C. C. A. 5th), the taxpayer received certain payments under oil and gas leases, one-half of which he was under firm obligation to pay over to the state. The court held that the taxpayer was liable for income tax only on one-half of the payments received be-

cause he had received the other half under no claim of right but merely as agent for the state. In this case, too, the *North American Oil* decision was expressly distinguished.

In *Stoner* v. *Commissioner,* 79 F. (2d) 75 (C. C. A. 3rd), the holding was merely that the payments to the taxpayer sought to be taxed were received by him in a fiduciary capacity and that during the tax year he had no absolute power of disposition over the fund.

In *Doyle* v. *Commissioner,* 110 F. (2d) 157 (C. C. A. 2d), petition for certiorari pending, October Term, 1940, No. 111, the taxpayers had contracted to sell a house which they owned prior to 1913. They received payments on account of the purchase price in 1929 and 1930 (the payments amounting to less than the 1913 value of the house), but the purchaser ultimately decided not to go through with the contract. In 1934, a suit for specific performance of the contract was decided against the taxpayers, but it was determined that they were entitled to keep the payments previously made. The court held that the payments were income subject to tax in 1934. It pointed out that in 1929 and 1930 the contract was still in the executory stage, the sale was not intended to be closed until a later year, and the payments consequently could not then be considered income rather than a return of capital. Only when the contract was finally ended in 1934 by the decree fixing the rights of the parties were the payments severed from a prospective sale

of the property and realized as a clear profit. Consequently, the payments became income only in 1934 and were taxable as such in that year.

4. The court below did not decide whether or not petitioner was entitled to a deduction because of its contingent liability to Shepard-Pendleton, but remanded the case to the Board for a determination of that question. Consequently, the issue cannot now be presented to this Court and petitioner's contention that, under California law, its agreement with Shepard-Pendleton constituted an equitable assignment of a portion of the recovery (Pet. 12) is not relevant to the disposition of the petition for certiorari.

CONCLUSION

The decision below correctly applies the rule of *North American Oil Consolidated* v. *Burnet, supra,* and is not in conflict with any decision of this Court or of any other circuit court of appeals. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted.

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